III.

STATEMENT OF THE CASE.

In the year 1916, the petitioner, an Ohio corporation, manufactured articles from which it derived a profit which was held to be subject to the tax imposed by Title III of the Revenue Act of 1916 and known as the munitions manufacturers' tax. The so-called munitions manufacturers' tax of the petitioner, imposed on profits made on munitions manufactured and sold in the year 1916, in the sum of $246,275.63, was paid to the United States Government by the petitioner in the year 1917. In its Federal income tax return for the year 1916, the petitioner did not deduct the said munitions manufacturers' tax from its gross income because said munitions manufacturers' tax was not paid in said year; but, having paid the said munitions manufacturers' tax in 1917, the petitioner deducted said tax from its gross income in its Federal income and profits tax returns filed with the United States Internal Revenue Department for the year 1917. The Commissioner of Internal Revenue disallowed the said munitions manufacturers' tax of $246,275.63, paid by the petitioner in the year 1917, as a deduction from the gross income of the petitioner for the year 1917, and transferred it back as a deduction from the gross income of the petitioner for the year 1916, in figuring the income and profits taxes of the petitioner for said years, and also deducted the amount of said munitions manufacturers' tax from the invested capital of the petitioner for the year 1917. The question at issue in this case is whether this action of the Commissioner of Internal Revenue (which resulted in a net increase of petitioner's Federal income and profits taxes for the years 1916 and 1917 of $175,053.35), was correct or incorrect. If incorrect, the petitioner, under the stipulation of facts made in this case, is admittedly entitled to recover from the respondent in this action the sum of $166,910.01, together with interest

thereon from July 14, 1923, at the rate of 6% per annum. (See Stipulation of Facts, Record, pp. 28-30.)

The case was tried to the District Court, a jury being waived in writing pursuant to the provisions of Section 649 of the Revised Statutes of the United States; and special findings of fact were duly requested by the parties and made by the District Court. (See Record, pp. 7-21 and 24-26.) The District Court rendered judgment for the respondent, which was affirmed by the Circuit Court of Appeals for the Sixth Circuit on April 2, 1929. (See Record, pp. 26 and 151.)

The facts involved in the case at issue are undisputed* and are as follows:

The Internal Revenue Law of 1913 (enacted October 3, 1913) provided as follows (Section G (b)) (38 Stat. 172):

> "Such net income shall be ascertained by deducting from the gross amount of the income of such corporation, joint-stock company or association, or insurance company, received within the year from all sources,
>
> (first) all the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property;
>
> (second) all losses actually sustained within the year and not compensated by insurance or otherwise, including a reasonable allowance for depreciation by use, wear and tear of property, if any; * * *
>
> (third) the amount of interest accrued and paid within the year on its indebtedness to an amount of such indebtedness not exceeding one-half of the sum of

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* See Record, p. 49, where the District Court said, "I cannot see that you folks differ about anything here as to the real facts," and Record, p. 10, where the District Court in its Memorandum Opinion said, "The facts on which this issue turns, are not really in dispute," and Record, p. 153, where the Circuit Court of Appeals said, "Since all facts are conceded, * * *."

its interest bearing indebtedness and its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year; * * *

(fourth) all sums paid by it within the year for taxes imposed under the authority of the United States or of any State or Territory thereof, or imposed by the Government of any foreign country."

Under the Internal Revenue Law of 1913, the only recognized basis for making income tax returns was that of actual receipts and disbursements (See Law Opinion 1059, Record, pp. 125 and 132, and argument of the Solicitor General, 269 U. S. 423, hereinafter quoted), and thereunder the Commissioner of Internal Revenue made the following rulings:

Regulations 33, Art. 156 (See Record, p. 133):

"Reserves for taxes cannot be allowed, as the law specifically provides that only such sums as are paid within the year for taxes shall be deducted."

Regulations 33, Art. 158 (See Record, p. 133):

"Deductions for taxes, however, should be the aggregate of the amounts actually paid, as shown on the cash book of the corporation."

A similar ruling was made as to interest.

Regulations 33, Art. 148 (See Record, p. 133):

"The interest to be deductible must have been computed on the proper principal at the contract rate and must have been actually paid within the year."

While the United States Internal Revenue Law of 1913 required income tax returns to be made on the actual receipt and disbursement basis and the Regulations issued by the Commissioner of Internal Revenue specifically provided that reserves for taxes could not be allowed and that

interest and taxes could be deducted from gross income only in the year when actually paid, yet the Regulations issued by the Commissioner of Internal Revenue required that the gross income of manufacturing companies should consist of the total sales of manufactured goods during the year covered by the return, increased or decreased by the gain or loss as shown by the inventories of finished and unfinished products, raw material, etc., at the beginning and end of the year, and the Commissioner of Internal Revenue ruled that accounts and bills receivable of a corporation were to be treated as income for the year in which they were created, that is to say, in the year in which the accounts were set up on the books or the bills receivable were accepted, and that accounts payable, representing the ordinary and necessary expenses of maintaining and operating the corporation's business and property, might be deducted from the gross income of the year in which the expenses were incurred.

See Regulations 33, Art. 104 (Record, p. 134), which provides as follows:

> "Gross income of manufacturing companies shall consist of the total sales of manufactured goods during the year covered by the return, increased or decreased by the gain or loss as shown by the inventories of finished and unfinished products, raw material, etc., at the beginning and end of the year."

and letter addressed to Carey, Piper and Hall, Baltimore, Maryland, signed by Acting Commissioner David A. Gates and dated March 2, 1915 (Record, p. 133), wherein the Acting Commissioner says:

> "Accounts payable, representing ordinary and necessary expenses of maintaining and operating the business and property of a corporation, if actually charged into the Expense Account and so entered on the books as to constitute a liability against the assets of the company, and so treated in the preparation of

the return of annual net income that they will not be included in the deductions in the year in which they are actually paid in cash, or its equivalent, such accounts payable may be deducted from the gross income of the year in which the expenses were incurred.

"This ruling applies only to accounts payable representing ordinary and necessary expenses of maintaining and operating the business, that is, to such expenses as are incurred by the corporation in producing the gross income which it is required to return.

"Accounts and bills receivable of a corporation are to be treated as income for the year in which they are created, that is to say, in the year in which the accounts are set up on the books or the bills receivable are accepted."

From the foregoing, it will be seen that the rulings of the Commissioner of Internal Revenue under the Internal Revenue Act of 1913 were that the income tax returns under that law must be made on an actual receipt and disbursement basis, but that manufacturing corporations were not only permitted, but obliged by the method of computing gross income required by Art. 104 of Regulations 33 promulgated by the Commissioner of Internal Revenue, to use inventories and to treat bills and accounts receivable and payable representing sales of products and purchases of materials and other costs of goods as actual receipts and disbursements. In other words, the Commissioner of Internal Revenue ruled that the actual receipt and disbursement basis of figuring and reporting income, required by the Internal Revenue Law of 1913, was not violated by using inventories or by treating bills and accounts receivable and payable arising from its manufacturing operations as actual receipts and disbursements of the dates when they were entered on the company's books.

Pursuant to the foregoing regulations and rulings of the Commissioner of Internal Revenue, the petitioner re-

ported its income for the year 1915, in its Federal income tax return for that year, on the basis of cash receipts and disbursements, using inventories in figuring gross income and treating its ordinary bills and accounts receivable and payable, arising in the operation of its manufacturing business, as cash receipts and disbursements on the dates on which they were entered on the Company's books (See Record, pp. 32, 34 and 35).

On September 8, 1916, a new Federal income tax law was passed. This law contained the following provisions (39 Stat. 767):

> "Sec. 12. (a) In the case of a corporation, joint-stock company or association, or insurance company, organized in the United States, such net income shall be ascertained by deducting from the gross amount of its income received within the year from all sources—
>
> First. All the ordinary and necessary expenses paid within the year in the maintenance and operation of its business and properties, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the corporation has not taken or is not taking title, or in which it has no equity.
>
> Second. All losses actually sustained and charged off within the year and not compensated by insurance or otherwise, including a reasonable allowance for the exhaustion, wear and tear of property arising out of its use or employment in the business or trade; * * *
>
> Third. The amount of interest paid within the year on its indebtedness to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding; * * *

Fourth. Taxes paid within the year imposed by the authority of the United States, or its Territories, or possessions, or any foreign country, or under the authority of any State, county, school district, or municipality, or other taxing sub-division of any State, not including those assessed against local benefits."

It will be noted that the above quoted provisions of Section 12(a) of the Internal Revenue Law of September 8, 1916, are substantially identical with the corresponding provisions of Section G(b) of the Internal Revenue Law of 1913 hereinabove quoted.

The Internal Revenue Law of 1916 also provided as follows:

Sec. 13. (39 Stat. 771)

* * * * *

"(d) A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned;"

On September 14, 1916, W. H. Osborn, Commissioner of Internal Revenue, issued the following ruling (See Record, p. 134):

"Pending the adoption and promulgation of special regulations under the Act of September 8, 1916, Income Tax Regulations in force September 8, 1916, are hereby extended and made applicable to the Act of September 8, 1916, so far as not inconsistent with the provisions of that statute."

On January 8, 1917, the Commissioner of Internal Revenue made the following ruling, T. D. 2433 (See Record, pp. 134-136):

"Sub-paragraph (d) of Sec. 13, of Title I, of the Act of September 8, 1916, provides that

> 'A corporation, joint stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue with the approval of the Secretary of the Treasury, make its returns upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.'

"Under this provision it will be permissible for corporations which accrue on their books monthly or at other stated periods, amounts sufficient to meet fixed annual or other charges, to deduct from their gross income the amounts so accrued, provided such accruals approximate as nearly as possible the actual liabilities for which the accruals are made, and provided that in cases wherein deductions are made on the accrual basis as hereinbefore indicated, income from fixed and determinable sources accruing to the corporations must be returned, for the purpose of the tax, on the same basis.

"In cases wherein, pursuant to the consistent practice of accounting of the corporation, * * * corporations set up and maintain reserves to meet liabilities, the amount of which and the date of payment or maturity of which, is not definitely determined or determinable at the time the liability is incurred, it will be permissible for the corporations to deduct from their gross income the amounts credited to such reserves each year, provided that the amounts deductible on account of the reserves shall approximate as nearly as can be determined, the actual amounts which experience has demonstrated would be necessary to discharge the liabilities incurred during the year and for the payment of which additions to the reserves were made; * * *

* * * * *

> "If, upon investigation, it shall be found that returns made upon the basis of accruals and reserves, do not reflect the true net income, the corporation so failing in this way to return the true net income, will not thereafter be permitted to make its returns upon any basis other than that of actual receipts and disbursements."

It will be noted that the utmost effect that can be given to Sec. 13(d) of the Act of September 8, 1916, is simply that corporations which have kept their accounts on a basis other than that of actual receipts and disbursements, but have theretofore been obliged by law to report their income on an actual receipt and disbursement basis, are now permitted, if they so desire, to report their income upon the basis upon which they have kept their accounts. Section 13(d), however, in no way compels corporations under any circumstances to report their income on other than an actual receipt or disbursement basis, no matter how they have kept their books.

The Treasury Department's rulings and regulations, hereinabove quoted, remained unchanged down to and after July 12, 1917, the date when the petitioner's amended income tax return for the year 1916 was executed.

On account of the petitioner's bookkeeping department being behind in its work, the petitioner was obliged, in the first instance, to file a tentative, inaccurate return of income for the year 1916, and as soon as correct figures were available, to wit, in July, 1917, the petitioner filed an amended income tax return for 1916, which was made up by the petitioner's secretary and auditor in conjunction with a government auditor who was then at the petitioner's plant auditing the figures for the petitioner's income tax return and munitions manufacturers' tax return for the year 1916. (See Record, pp. 31, 32 and 37.)

The petitioner's amended income tax return for the year 1916 was made out as follows: The gross income from operations was figured in the method required by the form of Item 3(a) on the reverse side of the income tax return blank furnished by the Treasury Department, and the petitioner's ordinary bills and accounts receivable and payable, arising from its manufacturing operations, were treated as cash receipts and disbursements on the dates when they were entered on the books, and the other items, including rentals and interest and taxes, were actual cash receipts and disbursements during the year. (See Record, pp. 31, 32, 34, 35, 36-40, 69 and 73.) The petitioner's secretary was familiar with the Treasury Department's regulations and rulings governing actual receipt and disbursement returns (See Record, pp. 33, 34 and 38); and a comparison of the petitioner's income tax return with the Treasury Department's regulations and rulings hereinabove cited will disclose that the petitioner's amended income tax return was made out in exact compliance with the Treasury Department's regulations and rulings then governing actual receipt and disbursement returns (See Record, p. 38).

The petitioner's amended income tax return for the year 1916, thus made out and filed by the petitioner in collaboration with the Internal Revenue Department's auditor, figured the income very differently from the income shown on the petitioner's books of account (See *infra*, pp. 12-13, as to the books of account) in that, subject to the questions, hereinafter discussed, as to the method of figuring gross income from operations by the use of inventories and the treatment of ordinary bills and accounts receivable and payable, arising from the petitioner's manufacturing operations, as cash receipts and disbursements, the accruals and reserves on the petitioner's books of account were omitted in figuring the petitioner's income tax return (See

Record, pp. 32, 35 and 36-37). For example, the taxes actually paid by the petitioner during the year 1916 and the taxes deducted in the petitioner's income tax return for the year 1916 amounted to $26,493.44 (See Record, pp. 32 and 84); whereas the taxes accrued, or for which reserves were set up, on the petitioner's books, during the year 1916, amounted to $130,924.19 (See Record, pp. 37 and 51 and Plaintiff's Exhibit No. 5, following p. 122).

The petitioner made out its amended income tax return for the year 1916 in exactly the same way as it had done the previous year (See Record, p. 34), and did not elect to avail itself of the privilege granted by Section 13(d) of the Act of September 8, 1916, to make its return upon the basis upon which its accounts were kept, unless, as contended by the respondent, the filing of said return, in itself, conclusively constituted such election, the petitioner's intention to the contrary notwithstanding (See Record, p. 32). Moreover, in answer to the question on the income tax return blank for the year 1916, "State whether or not this return is made on the basis of actual receipts and disbursements," the petitioner answered, "Yes." (See Record, p. 81). The petitioner's amended income tax return for the year 1916 was audited and approved, as filed, by the Treasury Department, and this audit and approval has never since been modified or questioned by the Treasury Department except as to the one item of the munitions manufacturers' tax deduction (See Record, pp. 32 and 37).

During the years 1916 and 1917 and previous thereto, the entries in the petitioner's books of account were made as follows: The entries in some accounts were made on the so-called "accrual basis"; the entries in some accounts were made when the invoices of the items were made out or received by the petitioner; and the entries in some accounts were made on the basis of actual cash receipts and

disbursements. That the foregoing statement is true is amply shown by the petitioner's testimony (See Record, pp. 32, 34, 39 and 41) and expressly admitted by one of the respondent's accountants who testified in this case (See Record, p. 46).

The munitions manufacturers' taxes of the petitioner were never accrued on its books, nor were any reserves ever set up against its munitions manufacturers' taxes (See Record, p. 29),—the petitioner's munitions manufacturers' taxes being one of the accounts set up on the petitioner's books on an actual receipt and disbursement basis. The first and only entry with reference to the munitions manufacturers' tax, which appears on the petitioner's books, was in July, 1917, when the payment of the tax was entered on the petitioner's books on the date when it was actually paid (See Record, pp. 33 and 40).

On October 3, 1917, paragraphs third and fourth of Subdivision (a) of Section 12 of the Act of September 8, 1916, were amended so as to read as follows, the italics indicating the words and clauses added by amendment (40 Stat. 335):

> "Third. The amount of interest paid within the year on its indebtedness (*except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt from taxation as income under this title*) to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding:
>
> * * * *
>
> "Fourth. Taxes paid within the year imposed by the authority of the United States (*except income and excess profits taxes*), or *of* its Territories, or possessions, or any foreign country, or *by* (under) the au-

thority of any State, county, school district, or municipality, or other taxing subdivision of any State, not including those assessed against local benefits."

It will be noted that the only substantial change in the clause covering the deduction of taxes is that Federal income and excess profits taxes are excepted from the taxes which may be deducted from gross income in figuring taxable income.

On December 17, 1917, the Commissioner of Internal Revenue issued the following ruling (See Record, p. 136):

> "These provisions of law (Sec. 13(d) of the Act of September 8, 1916) authorize corporations and joint stock companies, or associations, and insurance companies, keeping books of account on an accrued basis, to deduct from gross income in returns of annual net income the accrual of interest for the return year within the limits prescribed by the taxing acts when shown as a charge against accrued income upon the books of account."

Here again it will be noted that the change from an actual receipt and disbursement basis to an accrual basis, in making income tax returns, is purely permissive and not obligatory.

There were no other pertinent income tax rulings made prior to March, 1918, when the income tax returns for the year 1917 had to be filed, Article 191 of Regulations 33, as it stood in March, 1918, reading as follows (See Record, p. 136):

> "*Taxes deductible.*—Taxes imposed against a corporation by authority of the United States (except income and excess-profits taxes) its territories or any foreign country, or by authority of any State, county, school district, municipality, or other taxing sub-division of a State (not including those assessed against local benefits) and paid within the year for which the return is made, are deductible from the gross income of a domestic corporation."

The petitioner made out its income tax return for the year 1917 in exactly the same way that it had made out its income tax returns for the years 1915 and 1916, in strict compliance with the then regulations of the Treasury Department, governing actual receipt and disbursement returns, and the requirements of the income tax return blank (See particularly item 4(a), Record, p. 93) which the Treasury Department required to be used, and did not elect to avail itself of the privilege granted by Section 13(d) of the Act of September 8, 1916, to make its return upon the basis upon which its accounts were kept, unless, as contended by the respondent, the filing of said return, in itself, conclusively constituted such election, the petitioner's intention to the contrary notwithstanding (See Record, pp. 31, 32, 34-35, 37, 38 and 39). Moreover, in answer to the question on the 1917 income tax return blank, "Is this return made on the basis of actual receipts and disbursements?" the petitioner answered, "Yes, except as below indicated," and below it is stated that "Bills and accounts payable and receivable are treated as receipts and disbursements." (See Record, p. 98.)

IV.

SPECIFICATION OF ERRORS.

The petitioner duly excepted to the findings of fact and conclusions of law made by the District Court and to the judgment rendered by the District Court and to the failure of the District Court to make various findings of fact requested by the petitioner; but, as hereinabove set forth in the Statement of the Case, there is no dispute about the facts in this case and the ultimate question raised by the various exceptions taken by the petitioner is whether or not, on the established facts, the petitioner is entitled to judgment in this case, and the argument in this Brief will be addressed directly to this question.

V.

SUMMARY OF ARGUMENT.

UNDER THE UNITED STATES INTERNAL REVENUE LAW OF 1913, INCOME TAX RETURNS HAD TO BE MADE ON THE ACTUAL RECEIPT AND DISBURSEMENT BASIS, BUT THE REGULATIONS ISSUED BY THE COMMISSIONER OF INTERNAL REVENUE REQUIRED MANUFACTURING COMPANIES TO FIGURE GROSS INCOME BY THE USE OF INVENTORIES AND THE COMMISSIONER OF INTERNAL REVENUE RULED THAT ACCOUNTS AND BILLS RECEIVABLE OF A CORPORATION WERE TO BE TREATED AS INCOME FOR THE YEAR IN WHICH THE ACCOUNTS WERE SET UP ON THE BOOKS OR THE BILLS RECEIVABLE WERE ACCEPTED AND THAT ACCOUNTS PAYABLE, REPRESENTING THE ORDINARY AND NECESSARY EXPENSES OF MAINTAINING AND OPERATING THE CORPORATION'S BUSINESS AND PROPERTY, MIGHT BE DEDUCTED FROM THE GROSS INCOME OF THE YEAR IN WHICH THE EXPENSES WERE INCURRED. RETURNS THUS MADE WERE REGARDED AND ACCEPTED BY THE COMMISSIONER OF INTERNAL REVENUE AS MADE ON THE BASIS OF ACTUAL RECEIPTS AND DISBURSEMENTS. THE UNITED STATES INTERNAL REVENUE LAW OF 1916 WAS SUBSTANTIALLY THE SAME, SO FAR AS PERTINENT TO THE CASE AT ISSUE, AS THE REVENUE LAW OF 1913, EXCEPT FOR THE OPTION GIVEN THE TAXPAYER AS HEREINAFTER SET FORTH; AND THE REGULATIONS ISSUED BY THE COMMISSIONER OF INTERNAL REVENUE UNDER THE REVENUE LAW OF 1913 WERE BY THE COMMISSIONER EXPRESSLY MADE APPLICABLE TO THE REVENUE LAW OF 1916. WHILE THE REVENUE LAW OF 1916 ALLOWED THE TAXPAYER TO MAKE ITS INCOME TAX RETURNS ON THE SAME ACTUAL RECEIPT AND DISBURSEMENT BASIS AS THE REVENUE LAW OF 1913, THE REVENUE LAW OF 1916 GAVE AN OPTION TO A CORPORATION KEEPING ACCOUNTS ON ANY BASIS OTHER THAN THAT OF ACTUAL RECEIPTS AND DISBURSEMENTS TO MAKE ITS INCOME TAX RETURNS UPON THE BASIS UPON WHICH ITS ACCOUNTS WERE KEPT. IN THE CASE AT ISSUE, THE PETITIONER NEVER EXERCISED THIS OPTION, BUT, ON THE CONTRARY, MADE OUT ITS INCOME TAX RETURNS FOR THE YEARS 1916 AND 1917 AS ACTUAL RECEIPT AND DISBURSEMENT RETURNS, IN EXACT AND COMPLETE COMPLIANCE WITH THE REGULATIONS AND RULINGS OF THE COMMISSIONER OF INTERNAL REVENUE THEN GOVERN-

ING ACTUAL RECEIPT AND DISBURSEMENT RETURNS, AND EXACTLY LIKE THE PETITIONER'S RETURNS UNDER THE REVENUE LAW OF 1913,—THE PETITIONER'S INCOME TAX RETURNS FOR THE YEARS 1916 AND 1917 REPORTING ACTUAL CASH RECEIPTS AND DISBURSEMENTS, SUBJECT TO THE USE OF INVENTORIES AND THE TREATMENT OF ACCOUNTS AND BILLS RECEIVABLE AND PAYABLE, AS ABOVE SET FORTH, A USE AND TREATMENT WHICH WERE THEN NOT ONLY PERMITTED BUT REQUIRED BY THE COMMISSIONER OF INTERNAL REVENUE IN ACTUAL RECEIPT AND DISBURSEMENT RETURNS. MOREOVER, THE PETITIONER'S INCOME TAX RETURNS FOR THE YEARS 1916 AND 1917 FIGURED THE INCOME VERY DIFFERENTLY FROM THE INCOME SHOWN ON THE PETITIONER'S BOOKS OF ACCOUNT, IN THAT THE ACCRUALS AND RESERVES SET UP ON THE PETITIONER'S BOOKS WERE ELIMINATED IN MAKING OUT THE TAX RETURNS AND THE TAX RETURNS WERE MADE SHOWING ACTUAL CASH RECEIPTS AND DISBURSEMENTS, SUBJECT TO THE USE OF INVENTORIES AND THE TREATMENT OF BILLS AND ACCOUNTS RECEIVABLE AND PAYABLE AS HEREINABOVE SET FORTH. MOREOVER, THE PETITIONER, IN ITS INCOME TAX RETURN FOR THE YEAR 1916, EXPLICITLY STATED THAT THE RETURN WAS MADE ON THE BASIS OF ACTUAL RECEIPTS AND DISBURSEMENTS, AND IN ITS INCOME TAX RETURN FOR THE YEAR 1917, EXPLICITLY STATED THAT THE RETURN WAS MADE ON THE BASIS OF ACTUAL RECEIPTS AND DISBURSEMENTS EXCEPT THAT BILLS AND ACCOUNTS PAYABLE AND RECEIVABLE WERE TREATED AS RECEIPTS AND DISBURSEMENTS. UNDER THE FOREGOING CIRCUMSTANCES, THE EVIDENCE IS CONCLUSIVE THAT THE PETITIONER MADE OUT ITS INCOME TAX RETURNS FOR THE YEARS 1916 AND 1917 ON THE ACTUAL RECEIPT AND DISBURSEMENT BASIS AS THEN PRESCRIBED BY THE COMMISSIONER OF INTERNAL REVENUE, AND DID NOT ELECT TO MAKE ITS INCOME TAX RETURNS ON THE BASIS ON WHICH ITS ACCOUNTS WERE KEPT OR ON THE SO-CALLED "ACCRUAL BASIS."

EVEN IF WE ASSUME THAT IT WAS IMPROPER FOR THE PETITIONER IN AN ACTUAL RECEIPT AND DISBURSEMENT RETURN TO USE INVENTORIES IN FIGURING ITS GROSS INCOME FROM OPERATIONS AND TO TREAT ACCOUNTS RECEIVABLE AND PAYABLE, ARISING OUT OF ITS MANUFACTURING OPERATIONS, AS CASH RECEIPTS AND DISBURSEMENTS ON THE DATES WHEN

THEY WERE ENTERED ON THE BOOKS, YET THE PETITIONER'S INCOME TAX RETURNS FOR THE YEARS 1916 AND 1917 HAVING BEEN AVOWEDLY MADE ON THE ACTUAL RECEIPT AND DISBURSEMENT BASIS AND HAVING BEEN MADE IN EXACT CONFORMITY WITH THE THEN REGULATIONS AND RULINGS OF THE COMMISSIONER OF INTERNAL REVENUE GOVERNING ACTUAL RECEIPT AND DISBURSEMENT RETURNS, THE ONLY CORRECTION, IF ANY, THAT THE COMMISSIONER OF INTERNAL REVENUE COULD PROPERLY HAVE MADE, IF HE HAD AFTERWARD CHANGED THE TREASURY DEPARTMENT REGULATIONS AND RULINGS, WAS TO CORRECT THE INCOME TAX RETURNS ON THE BASIS ON WHICH THEY WERE INTENDED TO BE MADE, TO WIT, THE ACTUAL RECEIPT AND DISBURSEMENT BASIS.

EVEN IF WE ASSUME THAT THE PETITIONER HAD ELECTED TO MAKE ITS INCOME TAX RETURNS FOR THE YEARS 1916 AND 1917 ON THE SAME BASIS ON WHICH ITS ACCOUNTS WERE KEPT, THE MUNITIONS MANUFACTURERS' TAX WOULD NOT HAVE BEEN DEDUCTED IN THE YEAR 1916 BUT IN THE YEAR 1917; FOR THE PETITIONER'S ACCOUNTS WERE KEPT ON SUCH BASIS THAT THE PETITIONER'S MUNITIONS MANUFACTURERS' TAX ACCOUNT WAS ENTERED ON ITS BOOKS ONLY ON AN ACTUAL DISBURSEMENT BASIS AND NOT ON AN ACCRUAL BASIS.

VI.

ARGUMENT.

The decision in the case at issue depends on the proper construction and scope to be given to the decisions and opinion of this Court in the cases of *United States vs. Anderson* and *United States vs. Yale and Towne Manufacturing Company*, 269 U. S. 422. In these cases, it was held as stated in the syllabus:

> "1. The Revenue Act of 1916 imposed a tax on net income and profits ascertained by deducting from gross income, expenses paid, losses sustained, interest and taxes paid during the calendar year, but provided, § 13(d), that 'a corporation * * * keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations of the

Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as returned.'

"*Held,* that where the taxpayer's books, reflecting its income, were kept upon an 'accrual' basis, i.e., by charging against income earned during the taxable period (1916) the expenses incurred in and attributable to the process of earning income during that period, and made its return upon that basis and not the basis of actual receipts and disbursements, it was permitted under the statute, as correctly construed by a Treasury regulation, to include in its deductions the amount of a 'reserve' entered on its books for taxes imposed by the United States on the profits of munitions made and sold by the taxpayer during that year, although the tax had not 'accrued' in the sense of having been assessed and become due; and that it was not permissible, as the taxpayer attempted, to defer deduction of the tax until the income return for the following year, during which the tax became due and was paid. Pp. 438, 441."

The courts below construed the opinion of this Court in the *Anderson* and *Yale and Towne Manufacturing Company* cases as holding that the combined effect of Sections 12(a) and 13(d) of the Internal Revenue Act of 1916 was that if the taxpayer "failed or was unable" to make its income tax return on a "*strict*" receipts and disbursements basis, the taxpayer was *required* to make its return on the "accrual basis"; that inventories and bills and accounts payable and receivable are not properly used in a "*strict*" receipts and disbursements return, and that, therefore, where the taxpayer used inventories and treated any bills and accounts receivable and payable as cash receipts and disbursements in its income tax returns, it had failed to make a return on a "*strict*" receipts and dis-

bursements basis and consequently its return must be made on an "accrual basis." This construction is based on the following italicized *obiter dicta* in this Court's opinion:

> "Standing by themselves and taken at their face value, these sections (Sections 12(a) and 13(d) of the Internal Revenue Act of 1916) would seem to require the taxpayer to make his return on the basis of receipts and disbursements or, in the alternative, on the basis of its own books of account if they reflect true income, under such regulations as the Commissioner may make, *and indeed to require the latter alternative if the taxpayer is unable to make his return on that basis.*" (269 U. S. 437)

and

> "It was to enable taxpayers to keep their books and make their returns according to scientific accounting principles, by charging against income earned during the taxable period, the expenses incurred in and properly attributable to the process of earning income during that period; *and indeed, to require the tax return to be made on that basis, if the taxpayer failed or was unable to make the return on a strict receipts and disbursements basis.*" (269 U. S. 440)

We respectfully challenge the accuracy and the soundness of the foregoing *obiter dicta,* and submit that the italicized statements could not possibly be correct statements of the law.

Section 12(a) of the Internal Revenue Act of 1916, like Section G(b) of the Internal Revenue Law of 1913, provided for an actual receipt and disbursement return. Section 13(d) of the Internal Revenue Act of 1916 merely gave to the taxpayer an option to make its income tax return on the basis on which its accounts were kept. This option the taxpayer might or might not exercise, as it deemed for its own best interests. *There is absolutely nothing in the law which can possibly be construed as*

obliging the taxpayer to exercise the option under any circumstances. There is nothing in the law which can possibly be construed as providing that in case the taxpayer "fails or is unable" properly to make out a "strict" receipt and disbursement return, then the Commissioner of Internal Revenue may compel the taxpayer to make out a return on the basis of the taxpayer's accounts. The law did not recognize any inability on the part of the taxpayer to make an actual receipt and disbursement return. During the period of seven years from 1909 to 1915 inclusive, all corporations were *required* to make out their excise and income tax returns on the actual receipt and disbursement basis. What was possible during the years 1909 to 1915 certainly was possible during the years 1916 *et seq.* Also, it may be noted that neither Section G(b) of the Internal Revenue Law of 1913 nor Section 12(a) of the Internal Revenue Act of 1916 provided for a "*strict*" receipt and disbursement return; for the deduction of depreciation was specifically allowed by the express provisions of each of these Sections. The receipt and disbursement returns required by Section G(b) of the Internal Revenue Law of 1913 and Section 12(a) of the Internal Revenue Act of 1916 have sometimes, not inaptly, been called "statutory" receipt and disbursement returns. It may, also, be mentioned that, as a matter of fact, it is certainly possible for any taxpayer keeping books of account on any basis to make an absolutely "strict" cash receipt and disbursement tax return. All one has to do is to use the entries of cash receipts and disbursements on the books. An actual receipts and disbursements basis may distort income to some extent as between different years, but if this be objectionable, the defect was in the laws permitting actual receipt and disbursement returns,—a defect which it is not the province of the courts to rectify. It may be added that in the Act of 1918, the Commissioner of Internal Revenue was

given power to redetermine the taxpayer's income on such basis as he might prescribe (See excerpt from *American Can Co. vs. United States,* cited *infra,* pp. 35-36), thus remedying the defect, if it be considered such, for 1918 and subsequent years. The petitioner therefore respectfully submits that it is a logical impossibility to say that the added option given the taxpayer in Section 13(d) of the Internal Revenue Act of 1916 could under any circumstances require the taxpayer to make its income tax returns on the basis of its accounts or on an accrual basis, if the taxpayer did not elect to do so.

As indicated by the foregoing discussion, the petitioner contends that the effects of Sections 12(a) and 13(d) of the Internal Revenue Act of 1916, upon the fair construction of this Court's opinion, as a whole, in the *Anderson* and *Yale and Towne Manufacturing Company* cases, are as follows:

Section 12(a) of the Internal Revenue Law of 1916 provided for an actual receipts and disbursements income tax return of exactly the same type and character as required by the Internal Revenue Law of 1913. Section 13(d) of the Internal Revenue Law of 1916 merely gave to the taxpayer an added option, which the taxpayer might or might not exercise, as it chose, to make its income tax return on the basis on which its accounts were kept. The initial question, therefore, is: Did the taxpayer make its return on an actual receipt and disbursement basis as that basis was then defined and required by the Treasury Department of the United States, or did the taxpayer elect to make its income tax return on the basis on which its accounts were kept? If the taxpayer elects to make its income tax return on the basis on which its accounts are kept, then the taxpayer must follow its accounts in making its income tax return; otherwise the taxpayer must make an actual receipt and disbursement return as then defined by the Treasury Department.

Cf. argument of Solicitor General Mitchell, found in 269 U. S. 423 and reading as follows:

> "Under the Revenue Act of 1916 a taxpayer was permitted to make his income tax return on an accrual basis if his books were kept on that basis. Corporation Excise Tax Law of 1909 plainly required the computation of net income on the basis of actual receipts and disbursements. There was no provision for accrual systems of accounting or for including items of expense incurred but not due and paid. The first corporation income tax Act of October 3, 1913, like the 1909 Act, provided for the calculation of net taxable income on the receipts and disbursements basis. Under these two Acts some departures from the strict receipts and disbursements basis were permitted by the Commissioner of Internal Revenue, such as the use of inventories. This legislation shows that the subject was undeveloped and the resulting system was a mongrel one, but, in the main, the returns were required to be made on a receipts and disbursements basis. *Lumber Mutual Fire Ins. Co. v. Malley,* 256 Fed. 380; *Maryland Casualty Co. v. United States,* 52 Ct. Cls. 201; same case, 251 U. S. 342. The first decided shift occurred in the Revenue Act of 1916, evidenced by the insertion of a new provision, § 13(d). This allowed the taxpayer the option to make his return on a cash basis without regard to how he kept his books, or if he kept his books on some other basis to make his return upon the basis upon which his accounts were kept."

In the case at issue, the petitioner made out its income tax returns for the years 1916 and 1917 on the basis of actual receipts and disbursements as then defined by the regulations and rulings of the Commissioner of Internal Revenue and in exact conformity with the Commissioner's regulations and rulings then governing actual receipt and disbursement returns, and the petitioner did not elect, under Section 13(d) of the Revenue Act of 1916, to make its

income tax returns on the basis on which its accounts were kept on its books.

As hereinabove shown in the Statement of the Case, the petitioner indisputably made out its income tax returns for the years 1916 and 1917 on the basis of actual receipts and disbursements, unless, as claimed by the respondent, the fact that the petitioner (to use the language of the respondent's witness) "used inventories in ascertaining their cost of goods, as well as the fact that they took the accounts receivable and the accounts payable in consideration as cash items," conclusively proves that the petitioner's income tax returns for the years 1916 and 1917 were made out on the so-called "accrual basis,"—it being the contention of the respondent that the method of arriving at gross income from operations by the use of inventories, in the manner set forth in Item 3(a) of the 1916 income tax return blank, and in Item 4(a) of the 1917 income tax return blank, plus the fact that bills and accounts receivable and payable arising in the course of the petitioner's manufacturing operations were treated as cash items on the dates when they were set up on the petitioner's books of account, render the petitioner's income tax returns for 1916 and 1917 so-called "accrual" returns and constituted an election on the part of the petitioner to avail itself of the privilege granted by Section 13(d) of the Revenue Act of 1916.

A review, however, of the regulations and rulings issued by the Commissioner of Internal Revenue prior to and during the years 1916 and 1917 and governing income tax returns for those years, shows clearly that the foregoing contention of the respondent is unsound. The Internal Revenue Law of 1913 *required* the taxpayer to make out income tax returns on the basis of actual receipts and disbursements (See Law Opinion 1059 and argument of

the Solicitor General, 269 U. S. 423, hereinabove quoted), and thereunder, as hereinabove set forth in detail in the Statement of the Case, while the regulations issued by the Commissioner of Internal Revenue provided that taxes, interest and other items must be reported for the years when the cash was spent out or taken in, yet these regulations *required* that the gross income of manufacturing companies, as reported in the income tax returns, should consist of the total sales of manufactured goods during the year covered by the return, increased or decreased by the gain or loss as shown by the inventories of finished and unfinished products, raw material, etc., at the beginning and end of the year, and the Commissioner of Internal Revenue ruled that accounts and bills receivable of a corporation *must* be treated as income for the year in which they were created, that is to say, in the year in which the accounts were set up on the books or the bills receivable were accepted, and that accounts payable, representing the ordinary and necessary expenses of maintaining and operating the corporation's business and property, might be deducted from the gross income of the year in which the expenses were incurred. The foregoing regulations and rulings under the Revenue Act of 1913, as hereinabove shown in the Statement of the Case, were by the Commissioner of Internal Revenue expressly extended to and continued in effect under the Revenue Act of 1916, which did not change or alter in any respect the right of the taxpayer to make its income tax returns upon the same actual receipt and disbursement basis which was required under the 1913 Act, but merely gave to a corporate taxpayer keeping accounts upon any basis other than that of actual receipts and disbursements an option, which it might or might not exercise, as the taxpayer deemed best, to make its income tax returns upon the basis upon which its accounts were kept.

The petitioner's income tax returns for the years 1916 and 1917 were made out by the petitioner's Secretary, who, at the time when he made out the returns, was familiar with the foregoing regulations and rulings, and these returns were made out by the petitioner's Secretary as actual receipt and disbursement returns, in exact conformity with the rulings and regulations of the Commissioner of Internal Revenue then governing such actual receipt and disbursement returns, and in exact compliance with the requirements of the form of income tax blanks furnished by the Internal Revenue Department and required to be used in making the income tax returns, and it was specifically stated on the income tax returns for the years 1916 and 1917 that the return was made on the basis of actual receipts and disbursements, it being added on the 1917 return that bills and accounts payable and receivable are treated as receipts and disbursements.

As above stated, there is no question but that the petitioner's income tax returns for the years 1916 and 1917 were actual receipt and disbursement returns, unless the two features testified to by the government's accountants, to wit, the use of inventories and the treatment of bills and accounts receivable and payable arising out of the petitioner's manufacturing operations, as cash receipts and disbursements, changed the returns into accrual returns. There can be no question but that the rulings and regulations of the Commissioner of Internal Revenue then in force were to the effect that these returns, as made out by the petitioner, were proper actual receipt and disbursement returns. There is no question but that the two features of the returns which are now claimed by the respondent to prevent the petitioner's returns from being actual receipt and disbursement returns, were features not only that the petitioner was then permitted to use in actual receipt and disbursement returns, but that the peti-

tioner *was then required* to use in actual receipt and disbursement returns, both by the regulations issued by the Commissioner of Internal Revenue, then in effect, and by the form of the income tax blanks required by the Internal Revenue Department to be used by the petitioner.* The petitioner's income tax returns for 1916 and 1917 were consequently proper actual receipt and disbursement returns *correctly* made out under the regulations and rulings of the Commissioner of Internal Revenue then in force, and thereunder, in such actual receipt and disbursement returns, taxes could be deducted only when paid.

The lower courts held that the foregoing argument had been rejected by this Court in the *Anderson* case (See Record, pp. 13 and 154).

In so holding, we submit that the lower courts have clearly fallen into error. The argument made in the *Anderson* case (See 269 U. S. 422, 438-439) was that inasmuch as the Treasury Regulations under the 1909 and 1913 Acts permitted the use of inventories and authorized the deduction of certain expenses although not paid, in ascertaining net income, but did not permit the deduction of taxes except in the year when paid, Congress by reenacting in §12(a) of the Act of 1916 the corresponding provisions of the earlier Acts, adopted the settled administrative practice, and that, accordingly, under that Act as well as under the earlier Acts, taxes could be deducted

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* It may be noted that when the Commissioner of Internal Revenue compelled the figuring of gross income from operations by adding sales and closing inventory and subtracting purchases and opening inventory, the Commissioner of Internal Revenue not only compelled the use of inventories, but also compelled the treatment of bills and accounts receivable, growing out of the sales, as cash receipts, and of bills and accounts payable, growing out of purchases of materials and other costs of goods, as cash disbursements; otherwise there would be a duplication in the receipts and in the expenditures used in figuring gross income, since the receipts and expenditures would be reported when the sales of products and purchases of materials were made, resulting in the creation of the accounts receivable and payable, and again when such accounts receivable and payable were paid.

only in the year when paid; but this Court said that Section 13(d) of the Act of 1916 gave to the taxpayer an option, not given in the earlier Acts, to report income on a different basis than that of actual receipts and disbursements, provided the taxpayer's books were kept on such different basis, and that, accordingly, a taxpayer keeping its books *and* reporting its income on an accrual basis must deduct taxes when accrued.

The argument advanced in the *Anderson* case is an entirely different argument than the proposition maintained by the petitioner in the case at issue. The petitioner in the case at issue does not maintain that it had no option to report taxes on the accrual basis if the tax accounts were kept in its books on that basis, but does maintain that the income tax returns filed by the petitioner for the years 1916 and 1917 were of the type and character that were then not only regarded but required by the Commissioner of Internal Revenue, as and for actual receipt and disbursement returns under the 1913 Act and the regulations issued thereunder, and under the 1916 Act and the Internal Revenue Commissioner's ruling of September 14, 1916, making the regulations under the 1913 Act applicable to the 1916 Act, and that it is impossible justly or logically to say that the petitioner, having made an income tax return of the type and character then prescribed and defined by the Commissioner of Internal Revenue for and as actual receipt and disbursement returns, can, by having filed such return, be deemed to have elected to make, or to have made, a so-called "accrual" return.

While it is not necessary to do so, we may call to the attention of the Court the fact that not only did the Treasury Department in 1916 and 1917 rule that manufacturing companies, in making out actual receipt and disbursement returns, *must* use inventories, but the United

States Government, through its Solicitor General, still maintains that this ruling is correct. See Brief recently filed with this Court by the Solicitor General in support of the petition of the United States for writs of certiorari in the cases of the United States, Petitioner, vs. American Can Company, the United States, Petitioner, vs. Missouri Can Company and the United States, Petitioner, vs. Detroit Can Company (October term, 1928, Nos. 128, 129 and 130), wherein the Solicitor General says (p. 20):

> "The case of *Doyle v. Mitchell Brothers Co., supra,* (247 U. S. 179) arose under the Corporation Excise Tax Act of August 5, 1909, which provided for the return of income on a cash receipts and disbursements basis only. The Court there said that the gross income of manufacturing companies 'should consist of the difference between the price received for the goods as sold and the cost of such goods as manufactured,' the cost to be ascertained by an addition of a charge to the account of goods as manufactured during the year of the sum of the inventory at the beginning of the year and a credit to the account of the sum of the inventory at the end of the year.
>
> "On a cash basis moneys spent for materials not used or sold during the year are not ordinary and necessary expenses but are investments in capital items and can not be deducted under the statutory provision any more than could the cost of the factory building. It is, therefore, necessary in computing income on a cash receipts and disbursements basis to take into account the increase or decrease in inventory during the year."

In the very recent case of *American Can Company vs. Bowers, Collector of Internal Revenue,* decided November 11, 1929, (Not yet officially reported—see the Corporation Trust Company's Standard Federal Tax Service (1929) Vol. 3, p. 8905) the United States Circuit Court of Appeals for the Second Circuit expressly holds that the regulations

issued by the Treasury Department, requiring the use of inventories in actual receipt and disbursement returns, were valid.

In this case the Court said:

> "Indeed, the appellants have failed to comply with the Departmental Regulation 33 (Revised) Articles 91 and 92, promulgated under the Act of 1917 which, in effect, require manufacturing and mercantile corporations to compute their income tax under the act in question through the use of inventories showing gross income as consisting of the difference between the price received for the goods sold and the cost of such goods as manufactured. *Such regulations are valid, whether applied to a cash or accrual basis of return.* (*Hays v. Gauley Mt. Coal Co.*, 247 U. S. 189)." (The Italics are ours.)

As hereinabove shown (footnote, p. 27), if gross income or cost of goods is required to be figured by the use of inventories as set forth in Item 3(a) of the 1916 income tax return blank and in Item 4(a) of the 1917 income tax return blank, such use of inventories also *compels* the treatment of bills and accounts receivable growing out of sales of products as cash receipts and of bills and accounts payable growing out of purchases of materials or other costs of goods as cash disbursements.

The authorities above cited seem ample to sustain the theoretical correctness, in accountancy, of the use of inventories and the treatment of bills and accounts receivable and payable arising out of manufacturing operations as cash receipts and disbursements, in "actual receipt and disbursement" returns, but, however this may be, as hereinabove set forth, the important indisputable fact is that such use and treatment were not only proper but required in actual receipt and disbursement returns under the rules and regulations of the Treasury Department for the years 1916 and 1917.

Suppose that the Internal Revenue Act of 1916 had contained Section 12(a) but not Section 13(d), would anybody contend that the petitioner's income tax returns for 1916 and 1917 were not proper receipt and disbursement returns under Section 12(a)? We think that surely no such contention would or could be made; for returns made out in the same identical manner as the petitioner's returns for 1916 and 1917 had been held to be proper receipt and disbursement returns for too many years. Yet how can the addition of Section 13(d), merely giving the taxpayer an option to make some other kind of return, render a return improper as a receipt and disbursement return under Section 12(a), which would be a proper receipt and disbursement return under Section 12(a) if Section 13(d) were not added?

It may be noted that the Circuit Court of Appeals, in its opinion in the case at issue, mentioned the item of depreciation as indicating an "accrual" return under Section 13(d) of the Internal Revenue Law of 1916, but this is clearly unsound for Section 12(a) of the Internal Revenue Law of 1916, like Section G(b) of the Internal Revenue Law of 1913, specifically provided for depreciation.

Even if there be a question as to the correctness of the use of inventories and the treatment of bills and accounts receivable and payable as actual receipts and disbursements, in actual receipt and disbursement returns, the evidence is conclusive that the petitioner never elected to change its income tax returns from the actual receipt and disbursement basis, required by the Law of 1913, to the basis on which its accounts were kept on its books, which was permitted by Section 13(d) of the Revenue Law of 1916. Besides the direct testimony of the petitioner's Secretary on this point (See Record, p. 32), the following facts are incontrovertible and decisive: The petitioner

never took any action under favor of said Section 13(d). It continued to keep its books of account after the passage of the Act of September 8, 1916, in exactly the same method that it had kept its books of account prior to the passage of the Act, and it continued to make its income tax returns to the Internal Revenue Department after the passage of the Act of September 8, 1916, in exactly the same manner in which it had made its returns prior to the passage of the Act. Furthermore, the petitioner neither before nor after the passage of the Act of September 8, 1916, made its income tax returns on the basis on which its accounts were kept. In the petitioner's books the entries in some accounts were cash receipt and disbursement entries; the entries in some accounts were made on the dates when the invoices of the items were made out or received by the petitioner; and the entries in some accounts were accruals and reserves. The petitioner's income tax returns figured the petitioner's income very differently from the income shown on the petitioner's books of account, in that the accruals and reserves set up on the petitioner's books of account were eliminated in making out the petitioner's income tax returns and the tax returns were made showing actual cash receipts and disbursements, subject to the use of inventories and the treatment of ordinary bills and accounts receivable and payable as hereinabove set forth. An example of the fact that the difference between the petitioner's books and the petitioner's income tax returns is not inconsiderable is found in the item of taxes for the year 1916. The taxes actually paid by the petitioner during the year 1916, and the taxes reported on the petitioner's income tax return for the year 1916 amounted to $26,493.44, whereas the taxes accrued or for which reserves were set up on the petitioner's books during the year 1916, amounted to $130,924.19. Moreover, the petitioner expressly declared in its income tax returns for 1916 and

1917 that the returns were made on a cash receipt and disbursement basis, adding in the 1917 return that bills and accounts receivable and payable are treated as receipts and disbursements.

Even if we assume that it was improper for a corporation, in an actual receipt and disbursement basis return, to use inventories in figuring its gross income from operations, and to treat its accounts receivable and payable, arising out of its manufacturing operations, as cash receipts and disbursements on the dates when they were entered on the books; even if we assume that the petitioner should have disobeyed the regulations and rulings promulgated by the Commissioner of Internal Revenue and disregarded the corporation income tax return blanks supplied by the Commissioner of Internal Revenue and by him required to be used by all corporations, and should have figured its gross income from operations without using inventories, and without considering sales of products or purchases of raw materials and the consequent bills and accounts receivable and payable; even on these assumptions, the only thing that the Commissioner of Internal Revenue had a right to do to correct the defect, was to correct the returns on an actual receipt and disbursement basis. The petitioner's income tax returns for 1916 and 1917 were avowedly made on an actual receipt and disbursement basis and it was so stated in the returns, and they were made in accordance with the then rules and regulations governing actual receipt and disbursement returns; and even if it be assumed that the items complained of by the respondent were not correctly reported in an actual receipt and disbursement return, the Commissioner of Internal Revenue had no right to shift the returns to an entirely new basis, but could properly correct the returns only on an actual receipt and disbursement basis,—the basis on which they were intended to be made.

Even if the petitioner had elected to make its income tax returns for the years 1916 and 1917 on the same basis as the basis on which its accounts were kept, the munitions manufacturers' tax would not have been deducted in the year 1916, but in the year 1917; for the petitioner's books of account were kept on a mixed basis, some accounts being accrued and some containing only actual receipt and disbursement items, and in the petitioner's books of account the petitioner's munitions manufacturers' tax was entered only on an actual disbursement basis. There was no entry with reference to the petitioner's munitions manufacturers' tax on its books during the year 1916. The first and only entry with reference to the petitioner's munitions manufacturers' tax was made in July, 1917, when the tax was paid. The petitioner's earnings statement for the year 1916, made out according to the accounts on its books, did not reflect the accrual or the payment of the munitions manufacturers' tax, and if the petitioner had made its income tax return for the year 1916 so that its income statement thereon jibed precisely with the income statement from its books, the munitions manufacturers' tax would not have been used as a deduction in 1916.

In the consideration of the foregoing point it should be remembered that Section 13 (d) of the Revenue Act of 1916 makes no use of the words "accrue" or "accrual" but merely permits a corporation to make its income tax returns on the basis on which its accounts are kept (See 269 U. S. 422, 441), and that in both of the two cases decided by this Court the corporation's accounts were so kept that the munitions manufacturers' tax was accrued on the corporation's books, while in the case at issue the petitioner's accounts were so kept that the petitioner's munitions manufacturers' tax was not accrued on the petitioner's books.

If it be argued by the respondent that the fact that the petitioner contested the munitions manufacturers' tax, as

applied to its products, may have been a reason why the tax was not accrued on the petitioner's books, a conclusive answer is that that fact would be a sufficient reason why the tax should not be accrued and why it should not be deducted in 1916.

If it be claimed that the mixed basis upon which the petitioner kept its books did not reflect true net income, then the Commissioner of Internal Revenue had but one alternative under the income tax law of 1916 and the rulings and regulations promulgated by the Treasury Department thereunder, and that was to correct the petitioner's income tax returns on an actual receipt and disbursement basis.

Treasury Decision 2433, Record, p. 141;

American Can Co. vs. United States, 31 Fed. Rep. (2nd) 730, (C. C. A., 3d Circ.).

In this case the Court said (p. 731):

"Since the basis used by the plaintiffs did not reflect their true income, to what basis could the Commissioner legally change? Section 13 (d) of title I of the Revenue Act of 1916, 39 Stat. 771, provides that:

"'(d) A corporation, joint-stock company or association, or insurance company, keeping accounts upon any basis other than that of actual receipts and disbursements, unless such other basis does not clearly reflect its income, may, subject to regulations made by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, make its return upon the basis upon which its accounts are kept, in which case the tax shall be computed upon its income as so returned.'

"Accordingly, if a corporation has kept its accounts upon a basis other than that of 'actual receipts and disbursements,' it may, subject to regulations of the Commissioner, with the approval of the Secretary of the Treasury, make its return upon that basis, and the tax on its income shall be computed as so returned,

if it clearly reflects its income; but, if it does not clearly reflect its income, then the tax must be computed on the cash, or receipts and disbursements, basis as prescribed in section 12, which provides that:

(Portions of Section 12 quoted)

"This is the receipts and disbursements, or cash, basis, and the tax must be assessed on this basis. (Citing authorities.)

"In the Act of 1918 (40 Stat. 1057, *et seq.*) Congress expressly conferred upon the Commissioner power to redetermine the income on such basis as he might prescribe; but he had no such power under prior acts, and, if the accrual or other basis used by the taxpayer in making his return did not reflect the true net income, he must use the cash basis.

"As the basis which the Commissioner used in redetermining the tax was not authorized in the Act of 1916, it was contrary to law, as found by the District Court. The tax which the District Court ordered refunded was the excess which the plaintiffs paid, computed on the receipts and disbursements basis, and was right in law and fact."

It will be noted that the foregoing decision of the Circuit Court of Appeals for the Third Circuit is in conflict with the decision of the Circuit Court of Appeals for the Sixth Circuit in the case at issue. In the case in the Third Circuit, the Circuit Court of Appeals held that under the Internal Revenue Law of 1916 the Commissioner of Internal Revenue could correct the taxpayer's income tax return *only on a receipt and disbursement basis,* even though the return was intended to be, in general, an accrual return, while in the case at issue, the Circuit Court of Appeals held that under the Internal Revenue Law of 1916 the Commissioner of Internal Revenue could correct the taxpayer's income tax return on an accrual basis even though the return was intended to be and was, at least in the main, an actual receipt and disbursement return.

The precise question involved in the American Can Company cases, to-wit, whether an arbitrary inventory write-up, overstating the inventory cost, constitutes a basis of keeping accounts, is, of course, not involved in the case at issue, and the decision of the Circuit Court of Appeals for the Second Circuit in the case of *American Can Company vs. Bowers, Collector,* hereinabove cited, that the inventory write-up involves merely an error in valuation figures and does not involve a basis of keeping accounts, is not contrary to the general principle laid down by the Circuit Court of Appeals for the Third Circuit and hereinbefore set forth, nor to the petitioner's contentions in the case at issue, but, on the contrary, presupposes and recognizes the general principle hereinbefore set forth. The exact *ratio decidendi* of the Circuit Court of Appeals for the Second Circuit is set forth in the following sentence:

> "The determination of the value to be placed upon an inventory has no relation to the principle or theory affecting the determination of when income is deemed to be received and when expenses are deemed to be incurred."

To say, as the respondent must, to succeed in the case at issue, that a corporation which has made its income tax return not only on a basis recognized under the then regulations and rulings of the Commissioner of Internal Revenue as an actual receipt and disbursement return, but in a form then required by the Commissioner of Internal Revenue for an actual receipt and disbursement return, and which, in its income tax return, has expressly declared the return to be an actual receipt and disbursement return, and which has made out its return on a basis different from the basis on which its accounts are kept,—to say that such corporation has elected to make an income tax return on an "accrual" basis or on the basis on which its accounts are kept, is, we submit, not only shockingly unjust but logically unthinkable.

It may be added that the petitioner's amended income tax return for the year 1916 was made out by the petitioner's secretary and auditor in collaboration with an auditor from the Internal Revenue Department, who, at the same time, made out the petitioner's munitions manufacturers' tax return for the year 1916, and audited both returns; that the income tax return so made out, audited and approved by the Internal Revenue Department, was indisputably made out in every respect on an actual receipt and disbursement basis, subject to the disputed questions as to the use of inventories and the treatment of bills and accounts receivable and payable as cash receipts and disbursements, and that the return so made out, audited and approved by the Internal Revenue Department's representative was palpably and indisputably very erroneous if made on an accrual basis. It should further be noted that the Internal Revenue Department has still left the petitioner's 1916 income tax return made out on the same actual receipt and disbursement basis as that on which it was made out by the government auditor in conjunction with the petitioner's representatives, except as to the one item of the munitions manfacturers' tax. For example, the Internal Revenue Department has not allowed a deduction in the petitioner's 1916 income tax return of the sum of $108,006.55, Federal income tax accrued for the year 1916,* together with certain other accrued taxes and large reserves, for the reason that the petitioner's 1916 income tax return *was* an actual receipt and disbursement return, and has deducted in the year 1916 a munitions tax alleged to have accrued in that year on the ground that the petitioner's 1916 income tax return *was not* an actual receipt and disbursement return but was a return made on the

*NOTE: 1916 income taxes deducted on an accrual basis would be deductible from 1916 income, but, since income taxes were made non-deductible in 1917, 1916 income taxes deducted on an actual disbursement basis would never be deductible.

"accrual" basis. Certainly the courts should redress such indefensible injustice.

As hereinabove indicated, the decisions of the courts below in the case at issue have been due to their belief that the decision of this Court in the case of *United States vs. Anderson* compels a like decision in the case at issue, and, as hereinabove indicated, we respectfully submit that the lower courts are in error in such belief.

The decision in the *Anderson* case was expressly put upon the ground that the record in that case failed affirmatively to show either that the company's books were kept *or* that the company's tax returns were made on the basis of actual receipts and disbursements. (See 269 U. S. 422, 433.) In the case at issue all of the facts bearing on the questions on what basis the petitioner's accounts were kept and, more particularly, on what basis its income tax returns were made, are before this Court, and it is clearly shown that the accounts in the petitioner's books were on a mixed basis but that the petitioner's income tax returns were made on an actual receipt and disbursement basis in every particular, subject to the controverted questions as to the effect of the use of inventories and the treatment of ordinary bills and accounts receivable and payable as cash receipts and disbursements.

Moreover, some of the differences, at least, between the facts in the *Anderson* case and the facts in the case at issue are shown by the records. In the *Anderson* case, large reserves, accrued on the books of the company, were used as deductions from gross income in making out the tax return. In the case at issue, such reserves, amounting to large sums of money, set up on the petitioner's books in the year 1916, were not used as deductions in making out the petitioner's tax returns. In the *Anderson* case, all income and expenditure items seem to have been reported on the accrual basis except the item of taxes. In the case at issue, the in-

come tax returns were actual receipt and disbursement returns in every respect, subject to the disputed questions as to the effect of the use of inventories and the treatment of ordinary bills and accounts receivable and payable as cash receipts and disbursements. In the *Anderson* case, there was no declaration of the taxpayer as to the basis on which it made its income tax returns. In the case at issue, the petitioner expressly declared in its income tax returns that it made the returns on the basis of actual receipts and disbursements.

In the *Anderson* case the taxpayer set up reserves for and accrued its munitions manufacturers' tax on its books, while in the case at issue, the petitioner's munitions manufacturers' tax was never accrued on its books nor were any reserves ever set up against said tax.

VII.

IN CONCLUSION.

In conclusion, we may sum up as follows:

Under the provisions of the United States Internal Revenue Act of 1916 and under the proper construction of the decisions and opinion of this Court in the cases of *United States vs. Anderson* and *United States vs. Yale and Towne Manufacturing Company,* hereinabove cited, a corporation was obliged to make its income tax returns for the years 1916 and 1917 on an actual receipt and disbursement basis, as then defined by the Commissioner of Internal Revenue, unless the corporation kept its accounts upon a basis other than that of actual receipts and disbursements, *and* unless the corporation elected to make its income tax returns upon the basis upon which its accounts were kept.

The petitioner's income tax returns for the years 1916 and 1917 were made on the basis of actual receipts and

disbursements, as then defined by the regulations and rulings of the Commissioner of Internal Revenue, and in exact conformity with the Commissioner's regulations and rulings then governing actual receipt and disbursement returns, and were expressly stated to be actual receipt and disbursement returns; and thereunder the petitioner's taxes could be deducted only in the year when actually paid.

The petitioner never exercised its option to avail itself of the provisions of Section 13 (d) of the Revenue Act of 1916, granting it the privilege of making its income tax returns on the basis on which its accounts were kept, as is conclusively proved, not only by the direct testimony of the petitioner's Secretary but by the following incontrovertible and decisive facts:

(a) The petitioner kept its books of account and made its income tax returns after the passage of the Revenue Act of 1916, containing Section 13 (d), in exactly the same way as it had previously done under the Revenue Act of 1913, proving that no action under Section 13(d) of the 1916 Act was ever taken by the petitioner.

(b) The petitioner's books of account were kept on a mixed basis, there being both cash receipt and disbursement accounts and accrued and reserve accounts on the petitioner's books, whereas the petitioner's income tax returns for the years 1916 and 1917 figured the petitioner's income very differently from the income shown on the petitioner's books of account, in that the accruals and reserves, amounting to large sums of money, set up on the petitioner's books of account, were eliminated in making out the petitioner's income tax returns, and the tax returns were made showing actual cash receipts and disbursements, subject to the use of inventories and the treat-

ment of bills and accounts receivable and payable growing out of its manufacturing operations as cash receipts and disbursements.

(c) The petitioner expressly said in its income tax returns for the years 1916 and 1917 that these returns were made on the actual receipt and disbursement basis.

Even if we assume that it was improper for the petitioner in an actual receipt and disbursement return to use inventories in figuring its gross income from operations, and to treat bills and accounts receivable and payable, arising out of its manufacturing operations, as cash receipts and disbursements on the dates when they were entered on its books, and that the petitioner should have disobeyed the regulations and rulings of the Treasury Department, obliging such use of inventories and such treatment of bills and accounts receivable and payable, yet the income tax returns, having been avowedly made on the actual receipt and disbursement basis, and having been made in exact conformity with the regulations and rulings of the Treasury Department then governing actual receipt and disbursement returns, and in full compliance with the form of corporation income tax return which the Treasury Department supplied and required to be used by the petitioner, the only correction, if any, that the Commissioner of Internal Revenue could properly have made, if the Treasury Department had subsequently changed its regulations and rulings governing actual receipt and disbursement returns, was to correct the income tax returns on the basis on which they were intended to be made, to wit, the actual receipt and disbursement basis.

Even if we assume that the petitioner had elected to make its income tax returns for the years 1916 and 1917 on the same basis on which its accounts were kept, the

munitions manufacturers' tax would not have been deducted in the year 1916 but in the year 1917, for the petitioner's accounts were kept on such basis that the petitioner's munitions manufacturers' tax account was entered on its books only on an actual disbursement basis and not on an accrual basis.

If it be claimed that the mixed basis upon which the petitioner kept its books did not reflect true net income, then the Commissioner of Internal Revenue had but one alternative under the income tax law of 1916 and the rulings and regulations promulgated by the Commissioner of Internal Revenue thereunder, and that was to correct the income tax returns on an actual receipt and disbursement basis.

The decision of this Court in the case of *United States vs. Anderson,* 269 U. S. 422, does not control the decision in the case at issue for at least three reasons.

In the first place, the record before this Court in the *Anderson* case did not affirmatively show that the taxpayer's income tax return was made on the basis of actual receipts and disbursements, but on the contrary apparently indicated that the return reported all items on the accrual basis except the item of taxes; whereas in the case at issue the petitioner's income tax returns for 1916 and 1917 were indisputably made on an actual receipt and disbursement basis in every particular, subject to the controverted questions as to the effect of the use of inventories and the treatment of ordinary bills and accounts receivable and payable as cash receipts and disbursements. For example, the record in the *Anderson* case showed that large reserves had been deducted in figuring income in the taxpayer's income tax return, while in the case at issue the record shows that large reserves set up on the petitioner's books of account were not deducted in figuring the petitioner's income in its income tax returns.

In the second place, in the *Anderson* case there was no declaration of the taxpayer as to the basis on which it made its income tax returns, whereas in the case at issue the petitioner expressly declared in its income tax returns that it made the returns on the basis of actual receipts and disbursements.

In the third place, in the *Anderson* case a reserve for the munitions manufacturers' tax was set up on the taxpayer's books in the year 1916, and an income tax return for the year 1916, made on the basis on which the taxpayer's accounts were kept, would contain a deduction of a munitions manufacturers' tax accrual; whereas in the case at issue, the petitioner's munitions manufacturers' tax (as well as the items in some other accounts) was not accrued on the petitioner's books, nor were any reserves ever set up against said tax, so that an income tax return for the year 1916, made on the mixed basis on which the petitioner's accounts were kept, would *not* contain any deduction of an accrued munitions manufacturers' tax.

The decision in the *Anderson* case, under the facts as found by this Court on the record in that case, is entirely in accord with the principles of law for which the petitioner herein contends, and the opinion of this Court in the *Anderson* case, with the exception of the two clauses of *obiter dicta* hereinabove discussed, lays down the principles of law for which the petitioner herein contends.

The great injustice to the petitioner of the decisions of the lower courts in this case, is manifest; for the petitioner, having religiously complied with the rules and regulations of the Treasury Department of the United States, governing actual receipt and disbursement returns, finds itself mulcted years afterward in the sum of $166,910.01 (besides the sum involved in a similar suit brought by the petitioner and now pending in the Court of Claims) on the basis of a repudiation, for the purposes of this case, of such

Treasury Department rules and regulations, by obedience to which the petitioner is alleged to have made a return on a basis never intended,—a basis not applied by the respondent except as to the one item of the munitions manufacturers' tax deduction, where it worked so harshly to petitioner's detriment.

WHEREFORE, it is respectfully submitted that the judgments of the Circuit Court of Appeals and of the District Court in this cause rendered should be reversed and that this case should be remanded to the United States District Court for the Northern District of Ohio, Eastern Division, with directions to enter judgment in this cause in favor of the petitioner for One Hundred and Sixty-six Thousand Nine Hundred and Ten Dollars and One Cent ($166,910.01), together with interest thereon from July 14, 1923, at the rate of six per cent (6%) per annum.

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